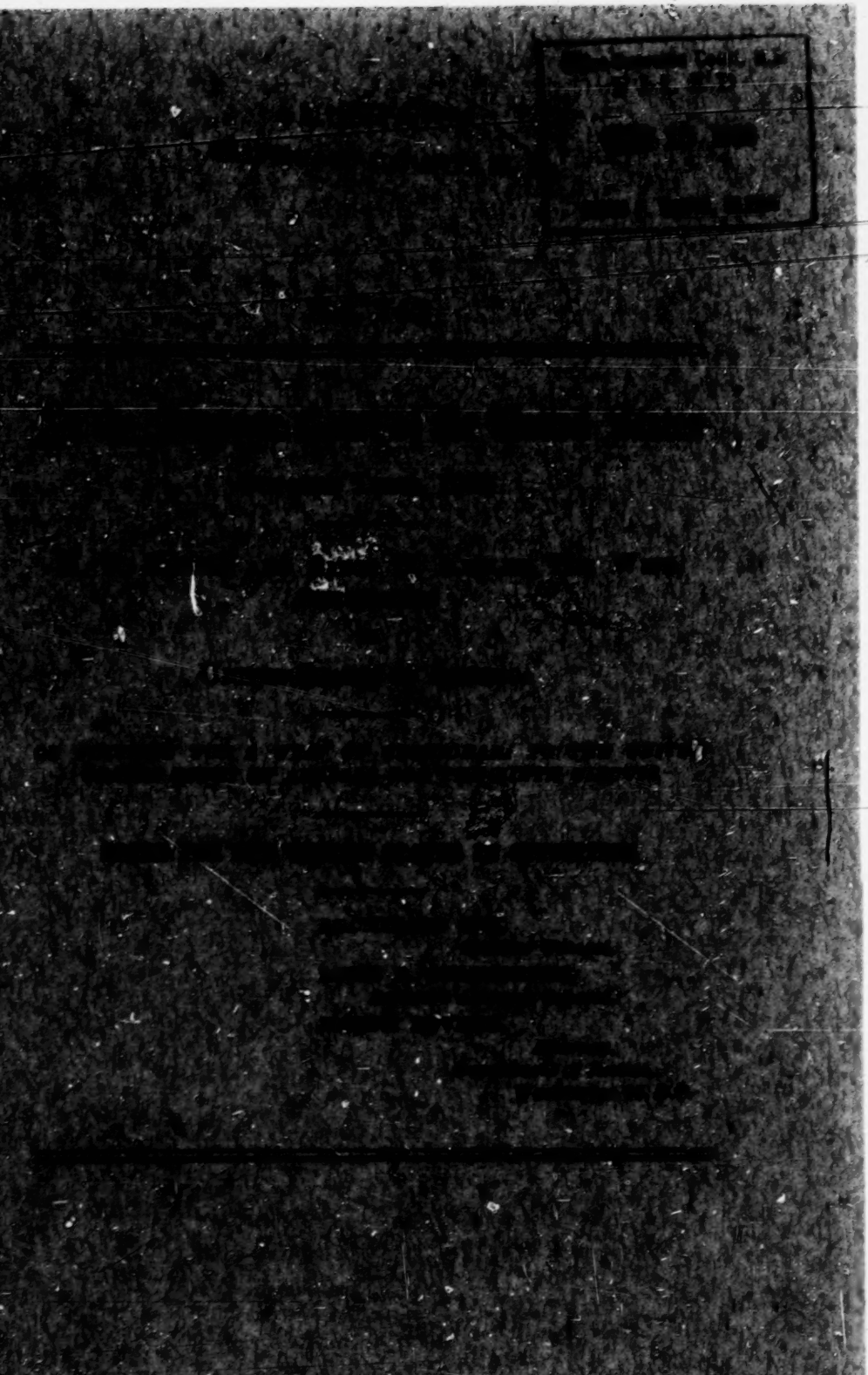

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In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 742

H. F. KEELER AND ALICE H. KEELER, HIS WIFE,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the Court of Appeals (Pet. App. B; R. 509–524) is not yet officially reported. The oral opinion of the district court (R. 391–408) is not reported.

JURISDICTION

The judgment of the Court of Appeals was entered September 20, 1962. (R. 525.) Petitioners' timely petition for rehearing in the Court of Appeals was denied by order dated October 22, 1962. (R. 526.) The time for filing the petition for a writ of certiorari was, on November 2, 1962, extended to and including

January 15, 1963. The petition was filed on January 12, 1963. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the Court of Appeals correctly held that the taxpayer's loss on loans to a Canadian corporation, of which he was a minority stockholder, operating an industrial laundry business in Toronto, Canada, was not incurred in the taxpayer's industrial laundry business in Seattle, Washington, but was a capital loss on an investment in the Canadian corporation.

2. Whether the Court of Appeals correctly held that the amount paid by the taxpayer pursuant to his agreement to reimburse other persons for losses incurred in the sale of their stock in the Canadian corporation was a capital loss, rather than an ordinary loss from a transaction entered into for profit.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 165 and 166 of the Internal Revenue Code of 1954, and of Treasury Regulations on Income Tax (1954 Code), Section 1.166–5(b), are printed in the Appendix, *infra*, pp. 17–19.

STATEMENT

This case arises out of the taxpayer's [1] suit for a refund of income tax for the year 1955, tried before a jury, but decided by the district court on cross-motions for a directed verdict. The record facts set

[1] The taxpayer's wife is involved only because a joint income tax return was filed.

forth in the opinion below (Pet. App. B, pp. 1–4, 8–9; R. 507–511, 515–516) can be summarized as follows:[2]

The taxpayer was engaged in the industrial laundry business in and around Seattle, Washington, under the name of Overall Cleaning and Supply Company, a co-partnership of which he owned and controlled 82.5%. It was stipulated that the taxpayer was not in the business of making loans, nor of promoting, organizing and financing business enterprises. In 1953, the taxpayer, together with two other individuals—Joseph W. Smith, who controlled an industrial laundry corporation in Portland, Oregon, and Henry Hoffman, who was also engaged in the industrial laundry business in Milwaukee, Wisconsin—formed a Canadian corporation, Northern Industrial Laundries, Ltd. ("Northern"), to engage in the industrial laundry business in Toronto. Out of a total investment in Northern of $610,000 in common and preferred stock and debentures, the taxpayer invested $95,770. The other shareholders in Northern, constituting a majority both in numbers and amount invested, had no connection with the taxpayer's Seattle laundry business.

At approximately the time of Northern's incorporation, the taxpayer, Hoffman and Smith encouraged a number of other persons (including the taxpayer's wife), referred to as the Hooker group, to purchase Northern stock and debentures by orally promising

[2] Most of the essential facts are stipulated. (R. 5–9.) The testimony at the trial was largely concerned with the reasons given by the taxpayer for making his investment in the Canadian corporation and accepting a compromise of the debt.

to reimburse them for any loss they might sustain on their investment, which amounted to $71,980.

The testimony showed that taxpayer, Smith and Hoffman considered Canada to be a ripe market for the industrial laundry business, and that they contemplated opening up industrial laundries in other Canadian cities after the Toronto plant became established. It was estimated that from one to three years would be required for the Toronto plant to become sufficiently successful to warrant starting the next laundry in the chain. Taxpayer anticipated "very material benefits" to his Seattle laundry business as the result of the formation of the Canadian chain of laundries. Among these expected benefits were (1) a pooling of purchasing power, with resultant lower prices to the Seattle plant; (2) the establishment of sufficient garment volume by joining the purchasing of garments by Hoffman's, taxpayer's and Smith's plants with the purchase of garments by the Canadian chain to justify establishing a garment manufacturing plant; (3) exchange of technical information; (4) the fact that if the Seattle plant were known to be connected with a chain, it would be less likely to encounter new competition in Seattle; (5) advertising advantages; and (6) the probability that taxpayer's Seattle laundry would obtain the patronage of the Seattle branch of any large concern which did business with any other plant in the chain.

The Canadian corporation commenced operations in Toronto on January 1, 1954 (R. 7). From the start, however, its operations were unsuccessful financially, and the taxpayer and Smith's Portland, Ore-

gon, corporation supplied Northern with additional working capital in the form of cash advances, payment of invoices and credit sale of used equipment. The taxpayer's advances to Northern totalled $132,336.11. In addition, the taxpayer, Smith and Hoffman, on January 7, 1954, executed a guaranty to a Canadian bank extending a line of credit to Northern up to the amount of $150,000.00. On January 15, taxpayer and Smith agreed to save Hoffman harmless from all claims with respect to the guaranty.

In October 1954, Northern executed demand notes to the taxpayer and to Smith's company. Each note represented the creditor's total advances to Northern ($130,000.00) plus his (or its) share of the guaranty to the bank ($75,000.00). The notes were secured by a mortgage on Northern's land and building (R. 8, Exs. 2, 4), which was later assigned to the bank as security in order to obtain an extension of its $150,000.00 loan to the corporation (R. 8, 344–345, 369, Ex. 16). Northern continued to lose money in its operations and was unable either to pay the $205,000 notes upon demand or to discharge the $150,000 obligation to the bank when it fell due. Eventually, in March 1955, the taxpayer and Smith entered into a compromise arrangement with the corporation. Estimating that the fair market value of the property covered by the mortgage was between $230,000 and $235,000, and wishing to avoid the expenses and uncertainties of foreclosure, the creditors agreed to accept value in the amount $232,000 in full satisfaction of their indebtedness. Of this amount, $82,000 was to be paid in cash—$43,747.21 to taxpayer

and the rest to Smith. The corporation was to discharge the remaining $150,000 by obtaining releases of taxpayer's and Smith's obligations as guarantors of the bank loan. Northern accepted this offer and the agreement was performed according to its terms. It is the difference between the $43,747.21, received by the taxpayer in cash pursuant to the above agreement, and the $132,336.11, representing his loans and advances to Northern—a difference of $88,588.90—which he now claims as an ordinary deduction in full, either as a business bad debt incurred in his Seattle business (26 U.S.C. 166(a)) or, alternatively, as a loss from a transaction entered into for profit (26 U.S.C. 165(c)(1)).

As a part of the same group of transactions, the taxpayer and others, including the Hooker group, sold their stock and debentures in Northern to certain Canadian investors—the "Mendelson group"—at a substantial loss. The taxpayer, Smith and Hoffman reimbursed the Hooker group under their oral indemnification agreement. The taxpayer's share of this reimbursement amounted to $13,694.99, which he claimed should be deductible in full as a loss on a transaction entered into for profit under Section 165, *supra,* although he conceded that the loss on the stock and debentures he purchased directly was a capital loss.

The government did not put in any evidence, but relied upon the stipulated facts, together with the exhibits and cross-examination of the taxpayer and Smith by reference to their depositions before trial. At the conclusion of the case, both the government

and the taxpayer moved for a directed verdict. (R. 30–31, 390.) In an oral opinion (R. 391–408) the district court ruled in favor of the taxpayer in respect to the loss on the debt owed to taxpayer by the Canadian corporation, holding that it was deductible in full as a business bad debt. However, it held against the taxpayer on the loss incurred in connection with the guaranty to the Hooker group. The jury returned its instructed verdict, and judgment was entered thereon. (R. 25, 26–27). The government then moved to have the verdict and judgment set aside and for judgment in accordance with its motion for a directed verdict or, in the alternative, for a new trial. (R. 28–30.) The taxpayer also moved for judgment in his favor as to the $13,694.99 deduction on the guaranty to the Hooker group. (R. 30–31.) Both motions were denied. (R. 31–32.) Upon cross-appeals, the court below sustained the government's appeal and denied the taxpayer's appeal, holding that the taxpayer's bad debt loss on his advances to the Canadian corporation were not incurred in his Seattle business and that the reimbursement of the Hooker group for the loss they suffered on the sale of their stock resulted in a capital, rather than an ordinary, loss.

ARGUMENT

1. (a) Section 166 of the Internal Revenue Code of 1954 (Appendix, *infra*, pp. 17–18) disallows bad-debt losses as a deduction in full from a taxpayer's ordinary income unless they are "incurred in [his] trade or business." The applicable Treasury Regulation

(Section 1.166–5; Appendix, *infra*, pp. 18–19) further requires that the relation between the debt and the business be "a proximate one." The taxpayer here conceded that he was not in "trade or business" because of making loans or of promoting, organizing, and financing business enterprises.[5] Hence, the issue is whether the taxpayer's loans to the Canadian corporation were incurred in—*i.e.*, proximately related to—his Seattle partnership business. Taxpayer's principal contention is that the court of appeals should either have affirmed the trial court's holding that the $88,588.90 loss involved here was proximately related to his business, or at least should have remanded the case to permit a jury determination of that issue. We maintain, on the contrary, that the court of appeals properly held, as a matter of law, that the loss did not bear the requisite relationship to the Seattle business.

First, the loans in question lack the direct and immediate relationship to the business which the regulation properly requires. The factual basis for taxpayer's claim is his testimony that if the Toronto enterprise were successful after two or three years, it would lead to a chain of industrial laundries in other Canadian cities, and if that materialized, his Seattle plant would then share in the combined purchasing power, technical experience, and other advantages made available by this chain. Characterizing these conjectural benefits as "more fanciful than real," especially in the light of the taxpayer's express re-

[5] Accordingly, the petition here does not involve the question presented in *Whipple* v. *Commissioner*, No. 305, this Term.

fusal to make his Seattle business a part of *any* chain, Canadian or American, the court below properly held that the claimed benefits to the Seattle business, even if taken at face value, did not meet the established legal tests of a close or proximate relationship. (Pet. App. B 9; R. 516.)

As the opinion demonstrates, this conclusion is in accord with the decisions of the Second, Fourth and Seventh Circuits, holding, on facts even more favorable to the taxpayer, that no proximate relationship existed between the taxpayer's bad debt and his trade or business. *Wheeler* v. *Commissioner,* 241 F. 2d 883 (C.A. 2d); *Gulledge* v. *Commissioner,* 249 F. 2d 225 (C.A. 4th), certiorari denied, 356 U.S. 959; *Allen* v. *Commissioner,* 283 F. 2d 785 (C.A. 7th). In *Gulledge,* the court denied a business bad debt, even though the debtor-corporation was formed to process peanuts for the benefit of the taxpayer and other farmers in the locality. In *Wheeler,* the court held that the taxpayer, a shipbuilder, could not claim a loss on loans to a separate shipbuilding corporation which he organized. The *Allen* facts are closely analogous to the facts at bar. There, the taxpayer, who operated a defense housing business in Milwaukee, sought a business bad-debt deduction for losses on loans to a Tucson venture engaged in defense housing projects, on the ground that the Tucson venture would furnish technical and other benefits to his Milwaukee operation. But the court held that these factors, though they may have motivated the taxpayer, were too remote to establish that proximate relationship of the loss to the taxpayer's business

which is prerequisite to full deductibility as a business bad debt.

Second, it is plain that any relationship the loan may have had to the Seattle business was greatly overshadowed by their relationship to his stockholder interest in the Canadian corporation. Indeed, the taxpayer neither alleged nor testified that the "material benefits" he anticipated for his Seattle business were the dominant consideration which led him to set up the Canadian corporation, and later to lend it money. He testified merely that the Seattle business was "a very definite factor" in his decision to undertake the Canadian venture; that he gave it "considerable weight"; and that he would not have invested in the corporation for the possible profit in the operation of the Ontario plant alone (R. 226). Thus, even if the evidence is viewed in a light most favorable to the taxpayer, it still fails, as a matter of law, to establish that the loan was "incurred in the taxpayer's trade or business."

(b) There is no conflict. On the contrary, the rule of the decision below and of *Wheeler*, *Gulledge* and *Allen* has been consistently followed by the courts of appeals. *O'Neill* v. *Commissioner*, 271 F. 2d 44 (C.A. 9); *Holtz* v. *Commissioner*, 256 F. 2d 865 (C.A. 9); *Commissioner* v. *Smith*, 203 F. 2d 310 (C.A. 2), certiorari denied, 346 U.S. 816; *Hickerson* v. *Commissioner*, 229 F. 2d 631 (C.A. 2); *Folker* v. *Johnson*, 230 F. 2d 906 (C.A. 2); *Commissioner* v. *Schaefer*, 240 F. 2d 381 (C.A. 2); *Towers* v. *Commissioner*, 247 F. 2d 233 (C.A. 2), certiorari denied, 355 U.S. 914; *Ferguson* v. *Commissioner*, 253 F. 2d 403 (C.A. 4); *Rollins*

v. *Commissioner*, 276 F. 2d 368 (C.A. 4); *Pokress* v. *Commissioner*, 234 F. 2d 146 (C.A. 5); *Omaha Nat. Bank* v. *Commissioner*, 183 F. 2d 899 (C.A. 8); *Skarda* v. *Commissioner*, 250 F. 2d 429 (C.A. 10). As the court below pointed out (Pet. App. B 11–12; R. 518–519), the several decisions relied upon by the taxpayer turn on their particular facts, and in each case the relationship between the loan and the business sought to be benefited was much more direct and immediate than the relationship alleged to be present here.

2. In the alternative, the taxpayer argues that the partial extinguishment of the corporation's indebtedness, effected by the compromise transaction of March 1955 (R. 133–137), was in reality a *quid pro quo* for obtaining a release of the taxpayer's guaranty obligation to the Canadian bank. As such, he maintains, it was not a bad-debt loss at all, but rather a loss "incurred in [a] transaction entered into for profit" (26 U.S.C. 165(c)(2)), and hence deductible in full from ordinary income. This contention, we submit, wholly misconceives the character of the loss and the circumstances under which it was incurred. The simple fact is that the taxpayer had made advances to the corporation in the amount of $132,000 and was able to recover only $43,500 of this debt.[1] By March

[1] Actually, the total indebtedness of the corporation to the taxpayer was $205,000, made up of the direct advances and the corporation's obligation to indemnify the taxpayer on his guaranty of one-half of the $150,000 bank loan. Indeed, as the admitted facts show (R. 8), the corporation executed its promissory note for $205,000 to the taxpayer, as evidencing its total indebtedness to him. The loss on the guaranty is a loss on a

1955 Northern was hopelessly insolvent, had defaulted in the payment of its demand note to taxpayer and Smith, and was unable to repay the $150,000 loan from the bank, which was then due (R. 8). It was estimated that the entire assets of the corporation—all of which were subject to a mortgage securing the debt to taxpayer and Smith and which they had been forced to assign to the bank—would, upon foreclosure, have yielded the taxpayer (after satisfaction of the bank's claim) no more than the $43,500 he agreed to accept (R. 123–135). In fact, no foreclosure was necessary, since a group of Canadian investors—the "Mendelson group"—arranged to purchase the stock and debentures of the American shareholders, and, in connection with that purchase, to pay the taxpayer and Smith that portion of their claim which they anticipated they could recover through a forced sale of the assets.[5] Both the taxpayer and Smith testified that

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bad debt, not on a transaction for profit. *Putnam* v. *Commissioner*, 352 U.S. 82. Hence the taxpayer here recovered all but $88,500 of the total indebtedness: $43,500 was paid in cash, and $75,000 was satisfied by a release from his guaranty. The taxpayer's argument separating the advances from the guaranty is thus wholly misconceived and directly contrary to *Putnam*.

[5] In the district court, the government sought to introduce into evidence (as Exh. A–1) a memorandum of an agreement between a trustee for the American shareholders, on the one hand, and the Mendelson group on the other hand, under which the latter agreed to purchase the stock and debentures of the American interests for a total price of $212,570, plus $82,000 in satisfaction of the mortgage and debt owed by the corporation to the taxpayer and Smith (see Govt. Br. in the C.A., pp. 23–25, 38–42). It was the government's contention that a portion of the amount received by the taxpayer and Smith on the sale of their stock should instead have been applied to the discharge of their claim on the note, in light of the settled rule that, in

the amount they received in settlement of their claim was the maximum that they could get. Under these circumstances, there can be no doubt that the unrepaid portion of the advances constituted a worthless debt and gave rise to a bad-debt loss.

Although the compromise arrangement did call upon the corporation to obtain from the bank a release of the taxpayer's guaranty, it would be absurd to conclude, as taxpayer does, that the $88,500 sum he "forgave" the corporation was a *quid pro quo* for that release, rather than a bad debt. In the first place, the bank would plainly not have demanded such a sum, or anything remotely approaching it, as the price of discharging the guaranty. On the contrary, since it was protected by the assignment of a mortgage covering property with a fair market value greatly in excess of its loan ($230,000 as against $150,000), the bank would probably have dispensed with the guaranty for a token sum. Moreover, inasmuch as the balance of the debt which the taxpayer agreed to forego was, by his own admission, unrecoverable in any case, it is clear that he gave up nothing of value and hence suffered no "loss" in order to secure the release. If it were shown that

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the event of insolvency, the claim of a corporation should be satisfied in full before any payments are made to stockholders. *W. D. Haden Co.* v. *Commissioner*, 165 F. 2d 588, 591–592 (C.A. 5); 15A Fletcher, *Corporations* (Perm. ed.), Section 7417; 16A *id.*, Section 8219. The Canadian law is to the same effect. See *Re Canadian Cordage & Mfg. Co.* (1923, 54 Ont. L. R. 486, 493–494. However, the proferred evidence was excluded by the district court (R. 199, 211, 265–303, 338–342) on the ground that the contention had not been mentioned in the pre-trial order framing the issues to be litigated.

funds which would otherwise have been applied to the satisfaction of taxpayer's claim against the corporation were instead paid by the Mendelson group (or by some other lender) to the bank in return for discharging the guaranty, it might perhaps be reasonable to treat that payment as a cost incurred by the taxpayer to obtain the release, reducing his bad-debt loss *pro tanto*. If, on the other hand, as seems much more likely, the release was given by the bank as a result of the repayment of the underlying loan[6] or the substitution of the new Canadian investors as guarantors, the taxpayer's $88,500 loss would plainly not be attributable to the guaranty. Since the record does not disclose what (if anything) the cost of the release actually was, who obtained it, or the manner in which it was procured, there is no basis whatever for treating all or any portion of the loss at issue here as other than a bad-debt loss.

We would add, moreover, without developing the point, that even if the partial extinction of the corporation's debt had been a *quid pro quo* for the discharge of the guaranty, it should not be treated as an ordinary loss, but rather as an addition to the basis of the taxpayer's stock, since the purpose of the underlying guaranty was to enhance the value of that stock. Congress, as this Court has held, intended to treat all nonbusiness investment alike, and there-

[6] Smith testified in his deposition that he assumed Mendelson had paid off the $150,000 bank loan (R. 494) though he testified at the trial that he did not know of his own knowledge where the corporation had obtained the funds with which to compromise the indebtedness (R. 156).

fore a loss resulting from a shareholder's guaranty should be assimilated to losses resulting from the purchase of shares, contributions to capital, and loans to the corporation—all of which receive only capital loss treatment. *Putnam* v. *Commissioner*, 352 U.S. 82, 92.

3. Finally, taxpayer urges that the $13,694.99 payment he made in order to indemnify the Hooker group for the loss they sustained on the sale of their stock should have been treated as a loss "incurred in a transaction entered into for profit" (26 U.S.C. 165(c)(2)) and thus allowed as a deduction in full. The court of appeals properly held, however, that the loss sustained by the taxpayer in an effort to induce the Hooker group to invest in the corporation was, in effect, an addition to the cost of the taxpayer's own investment, and, as such, was deductible only as a capital loss by virtue of Section 165(f) of the Code. The cogent reasons which led the court of appeals to this conclusion seem to us unanswerable, and we would add only one further consideration. An agreement to reimburse a stockholder for any loss he might incur on a subsequent sale of his stock is equivalent, in economic terms, to a commitment by the indemnitor to acquire the stock at its original purchase price whenever the stockholder wishes to sell, the indemnitor accepting the risk of depreciation in the market value of the securities. In the present case, if the taxpayer and his co-guarantors had purchased the stock of the Hooker group at its original price and thereafter resold it to the Mendelson group at a lower price, the taxpayer's loss would obviously have

been a capital loss. The result should not be different, we submit, merely because the guarantors omitted the intermediate steps of acquiring and reselling the stock themselves, and instead simply paid the Hooker group the difference between the original cost of their investment and the amount they were able to realize upon the sale to the Canadian purchasers.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

ARCHIBALD COX,
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JOSEPH KOVNER,
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MARCH 1963.

APPENDIX

Internal Revenue Code of 1954:

SEC. 165. LOSSES.

(a) *General Rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * * *

(c) *Limitation on Losses of Individuals.*—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

* * * * *

(26 U.S.C. 1958 ed., Sec. 165)

SEC. 166. BAD DEBTS.

(a) *General Rule.*—

(1) *Wholly worthless debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) *Partially worthless debts.*—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

* * * * * *

(d) *Nonbusiness Debts.*—

(1) *General rule.*—In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss

from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) [as amended by Sec. 8, Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606, 1608] *Nonbusiness debt defined.*—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) A debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(e) *Worthless Securities.*—This section shall not apply to a debt which is evidenced by a security as defined in section 165(g)(2)(C).

* * * * * * *

(26 U.S.C. 1958 ed., Sec. 166.)

Treasury Regulations (1954 Code):

SEC. 1.166-5 Nonbusiness debts.

* * * * *

(b) *Nonbusiness debt defined.*—For purposes of section 166 and this section, a nonbusiness debt is any debt other than—

(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially

the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. * * *

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